

What We Can Learn From the Early History of Sovereign Debt

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The Standard Story

- European monarchs were serial defaulters → poor access to credit
- In 1688 the English invented parliamentary control of debt → Improved access to credit
- Other European states eventually followed suit
- **Lesson:** Get your political institutions right; have a representative assembly with strong prerogatives.

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An Alternative Story

- Sovereign debt began Europe's city-states with perpetual annuities purchased by merchants who controlled government
- Some territorial states, such as the Dutch Republic, eventually adopted this model, as did Great Britain. Others were less successful.
- As the British parliamentary model spread, creditworthiness was highest when the vote was restricted to wealth holders.
- **Lesson:** What mattered was whether political institutions were biased in favor of creditors.

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Two Ways Of Thinking About Institutions and Debt

- 1 **The Impartial View:** Focus on constraints on the executive, transparency, monitoring, shared governance, but not on actor preferences
- 2 **The Distributive View:** Ask who gains most from repaying debt and whether political institutions give them power

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How I Will Proceed

- **First look at how sovereign debt began**
- Next ask which territorial states were successful at imitating the city-state model and why
- Consider the spread of British style parliamentary responsibility during the long nineteenth century (1789-1914)
- Finally, draw implications for today

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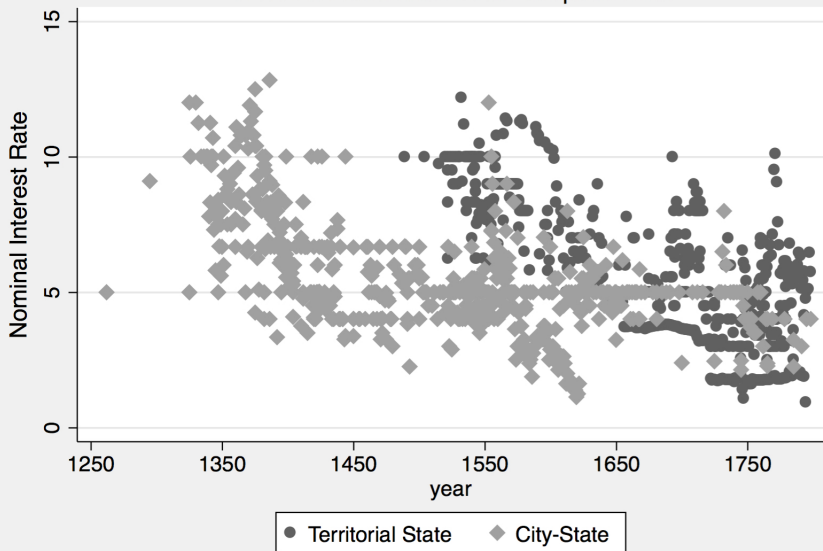
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How Sovereign Debt Began

The First Five Centuries of European Debt



What the Data Show

- Data drawn from a range of different secondary sources reported in Stasavage, *States of Credit* (2011).
- The vast majority of observations are returns on perpetual annuities.
- Statistically, city-states enjoyed a sizable (2 pct point) advantage up to the 18th century

What Explains the City-State Advantage?

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- 2 Adoption of techniques from trade finance? No
- 3 Abundant liquid capital? Not specific to city-states.

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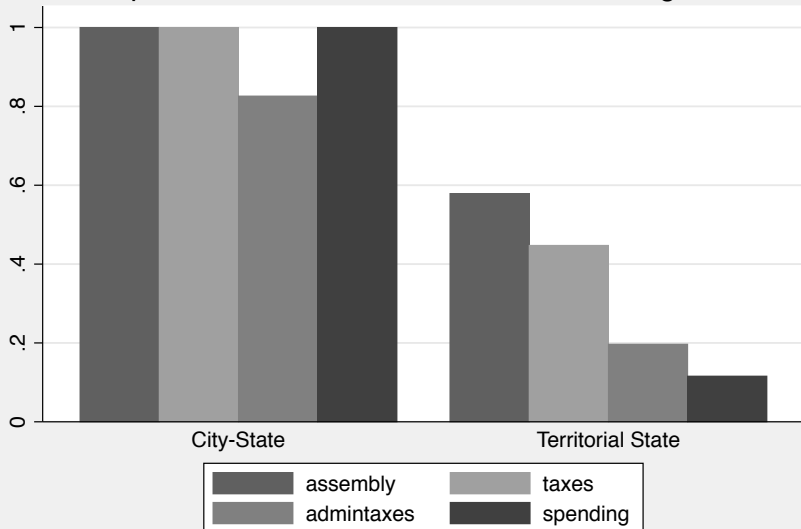
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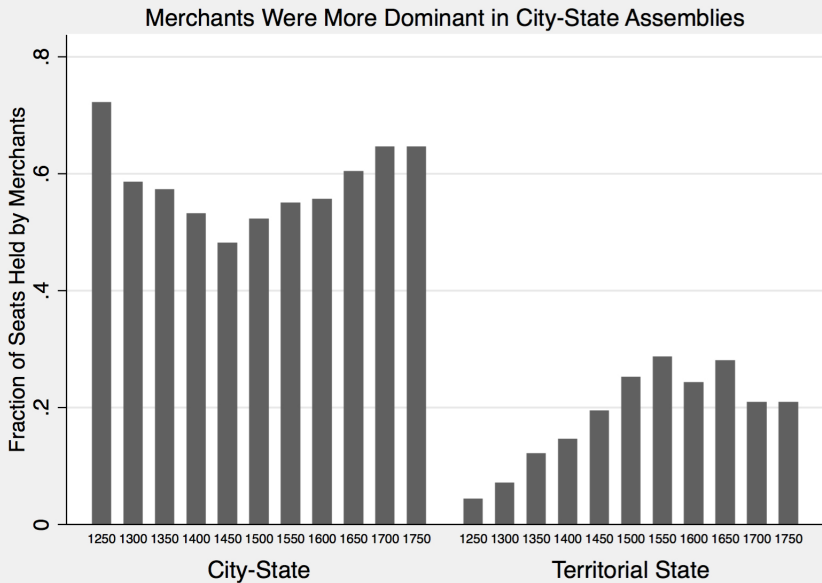
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Did Representative Institutions Make the Difference?

Representative Institutions and Their Prerogatives



Or Was it Merchant Power?



Assessing the Importance of Merchant Dominance

A difference in differences setting for 19 cities, half century time periods 1250-1800, clustered standard errors

$$\ln r_{it}^S = \alpha + \beta_1 M_{it} + \gamma \mathbf{X}_{it} + \eta_i + \theta_t + \varepsilon_{it} \quad (1)$$

$$\ln r_{it}^S - \ln r_{it}^L = \alpha + \beta_1 M_{it} + \gamma \mathbf{X}_{it} + \eta_i + \theta_t + \varepsilon_{it} \quad (2)$$

	(1) Rate	(2) Rate	(3) Spread	(4) Spread
Merchant >50%	-1.01 (0.34)	-0.82 (0.16)	-1.03 (0.35)	-1.45 (0.18)
Life annuities	0.52 (0.18)	0.61 (0.22)	0.40 (0.22)	0.62 (0.22)
Urbanization	-1.04 (0.54)	-0.61 (0.77)	-1.46 (0.67)	-0.45 (0.82)
City fixed effects	yes	yes	yes	yes
Year fixed effects	yes	yes	yes	yes
City time trends	no	yes	no	yes

Conclusion for city-states: Their creditworthiness depended on having institutions biased in favor of merchant creditors

How Larger States Imitated their Cities

Borrowing by Territorial States

- When larger states began borrowing they often imitated their cities
- Issuance of perpetual annuities, backed by revenues, monitoring by municipal institutions
- But the key was whether institutions were biased in favor or creditors

The Dutch Republic: The First Successful Case of Imitation

The Dutch Republic issued annuities, borrowing costs were low, and merchant creditors had preponderant influence in the Estates of Holland

Equitable or not, control of fiscal policy by men who themselves had heavy investments in state debt was the real genius of the Netherlands system of borrowing.¹

¹Tracy (1985 p.216)

Great Britain: A Second Successful Case of Imitation

- After 1688 Great Britain adopts the Dutch model for long term borrowing. It is first called "Dutch finance."
- The foundation of the British system was parliamentary responsibility of ministers
- However, it mattered how well creditors were represented in Parliament (Whig vs. Tory)
- Also, over time Great Britain relied increasingly on another solution similar to the Dutch - tax those who cannot vote

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France - Imitation that Failed

- In 1522 the French crown began selling annuities marketed by the municipality of Paris
- But government creditors were poorly represented in France's representative assembly

[i]f the affairs of the king are so desperate, he could make use of half of the rentes constituted on both the cities and communities of the kingdom, he could tax the financiers who have lent to him, or he could sell off church lands."

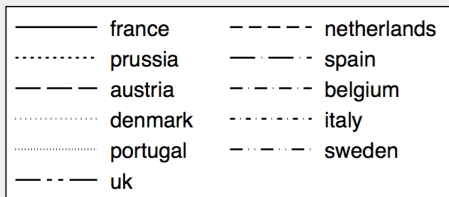
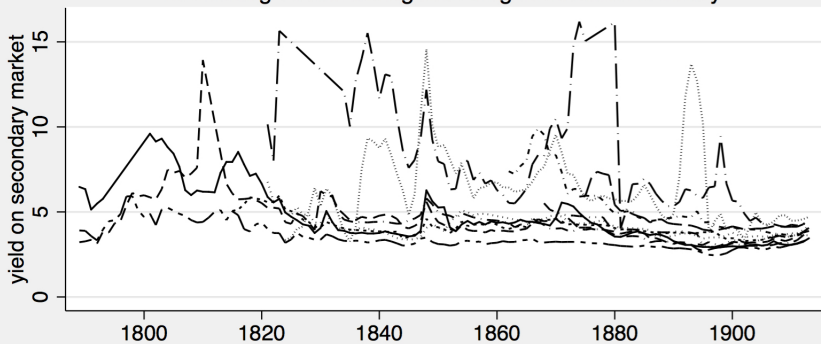
Conclusion for attempts to imitate: Imitation worked best when merchant creditors enjoyed the same political position that they did in city-states

The Diffusion of the British Parliamentary Model

The Evolution of Parliamentary Responsibility

- After 1688 a system evolved in Great Britain where crown ministers were responsible to the parliamentary majority
- During the long nineteenth century (1789-1913) this system spread to many other countries.
- **Question:** How did this institutional change affect government costs of borrowing?

Borrowing Costs During the Long Nineteenth Century



Once again a difference in difference setting, this time with annual data and secondary market yields

$$\ln r_{it}^S = \alpha + \beta_1 P_{it} + \beta_2 S_{it} + \beta_3 P * S_{it} + \eta_i + \theta_t + \varepsilon_{it} \quad (3)$$

$$\ln r_{it}^S - \ln r_{it}^{UK} = \alpha + \beta_1 P_{it} + \beta_2 S_{it} + \beta_3 P * S_{it} + \eta_i + \theta_t + \varepsilon_{it} \quad (4)$$

Results

	(1) Yield	(2) Yield	(3) Spread	(4) Spread
Lagged yield	0.80 (0.058)	0.76 (0.070)		
Lagged spread			0.79 (0.061)	0.76 (0.074)
Only responsibility	-0.029 (0.014)	-0.025 (0.013)	-0.025 (0.016)	-0.020 (0.014)
Only suffrage > 50%	-0.0039 (0.014)	0.0034 (0.014)	0.0027 (0.015)	0.012 (0.016)
Both	0.032 (0.016)	0.040 (0.019)	0.040 (0.018)	0.053 (0.021)
Country fixed effects	yes	yes	yes	yes
Year fixed effects	yes	yes	yes	yes
Country time trends	no	yes	no	yes


What Did People Say About the Suffrage? (1)

The root of the manifold evils from which Portugal has long suffered would undoubtedly seem to be what he [the Lisbon correspondent] declares it to be –namely, the Parliamentary system as it has been hitherto applied there. Portugal is blessed with a Constitution framed on the most liberal principles, but the masses of the people, unfortunately, seem to be hardly fitted to fulfill with discernment the responsible duties which it imposes upon them. The suffrage is extremely wide. All citizens who can read and write, or who pay taxes amounting to 500 reis –about 2s. 2 1/2d.– are entitled to the vote.²

²“The Situation in Portugal.” *Times*, 21 March 1908.

What Did People Say About the Suffrage? (2)

We would warn the new Government against the idea so prevalent in Latin countries that the mere establishment of a Republican Government and the waving of a Republican flag are enough to introduce an era of honesty and prosperity.³

³"The Revolution in Portugal" The Economist. 8 October 1910.      

Conclusion for Parliamentary Responsibility: Responsibility to Whom?

What Implications Can We Draw for Today?

- 1 **For Political Scientists:** Recognize the ambiguous effect of democracy
- 2 **For economists:** Need a class of models with heterogeneous endowments (as has been done in the capital taxation literature)
- 3 **For policymakers** Focus not just on fiscal rules and procedures but also on the preferences of those who enforce them
- 4 **Finally:** Consider who owns debt and how this might be changed

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